

TABLE OF CONTENTS

I.	Background	1
II.	My Duties and Responsibilities at AOL	1
III.	The Business of AOL	2
IV.	Browsers and Desktops	2
V.	AOL's Consideration of Licensing a Third Party Browser	3
VI.	The Competitive Environment	4
VII.	AOL's Negotiations with Netscape	7
VIII.	AOL's Negotiations with Microsoft	8
IX.	The Merits of the Two Browsers	12
X.	AOL's Relationship with Netscape Following the Microsoft Agreement	13
XI.	AOL's Other Agreements with Microsoft	13
XII.	AOL's Present Intentions Regarding Browsers	18
XIII.	Conclusion	19

DIRECT TESTIMONY OF DAVID M. COLBURN

Background

1. My name is David Martin Colburn. I am the Senior Vice President of Business Affairs for America Online, Inc. ("AOL").

2. I submit this written testimony in the consolidated matter of United States v. Microsoft Corporation, Civ. No. 98-1232, and State of New York et al. v. Microsoft Corporation, Civ. No. 98-1233, in accordance with the Court's Pretrial Order.

My Duties and Responsibilities at AOL

3. I joined AOL in September 1995. At the time, I was the Vice President of Corporate Development, reporting to Miles Gilburne, who was the Senior Vice President of Corporate Development. I am currently the Senior Vice President of Business Affairs, and in that capacity I report to Robert Pittman, AOL's President and Chief Operating Officer. I have been responsible for the negotiation of many of AOL's significant contractual relationships since I joined the company. I have also had primary oversight responsibility for administering and facilitating the implementation of certain of those contracts.

4. I was the lead negotiator for the various contracts between AOL and Microsoft during the period 1996 through 1998. I was also the lead negotiator for the various contracts between AOL and Netscape during that period. Thus, I am familiar with AOL's goals and interests in negotiating those contractual relationships.

The Business of AOL

5. AOL is a company that is primarily known for providing online services under the brands America Online and the recently-acquired CompuServe. In connection with these services, AOL distributes client software (i.e., software that resides on a customer's computer) through which subscribers to AOL's services, also known as members, have access to AOL's online content (including e-mail) and to the Internet. AOL provides a cross-platform software product; its client software can be used both on Windows-based and Macintosh computers. It is important to AOL that any software, including a browser, that is used in its client software have cross-platform capabilities.

6. The AOL Interactive Service currently has in excess of 13 million subscribers worldwide. The CompuServe Interactive Service, offered by AOL's CompuServe subsidiary, currently has approximately 2 million subscribers worldwide. AOL members each day generate over 1 billion web hits and send 34 million e-mails.

7. AOL distributes a browser to its members as part of its client software. Browsers are software applications that facilitate the viewing of information on the Internet. AOL adds, or integrates, browsers into its client software to provide its members with the ability easily to move back and forth between the features of AOL's online service and the Internet.

Browsers and Desktops

8. From AOL's perspective, a browser is a software application that is different from and not a part of the underlying operating system. Browsers are layered

on top of operating systems, and have the ability to act as a platform from which software applications and other programs on the Internet can be launched or driven. Browsers thus provide some of the platform characteristics of an operating system, since they can manage the calls to an operating system, although they are not themselves operating systems. From an application programmer's perspective, browsers can be a platform for which programs can be written, and can provide support across different operating systems.

9. A "desktop" refers to the first persistent screen typically seen by a computer user when turning on his or her computer, and to the software which supports the display and operation of the icons that appear on that screen. By placement of icons on the desktop, the desktop provider can direct or influence the navigation of a user to preferred functions and features of the operating system or to particular application programs or Internet destinations.

AOL's Consideration of Licensing A Third Party Browser

10. Beginning in the 1994 time frame, the Internet became an increasingly important element of the interactive marketplace. To enhance its members' ability to use the Internet, AOL needed to provide its members with a browser. In 1994, AOL purchased a browser company named Booklink and, in early 1995, began to distribute the Booklink browser to its subscribers as part of AOL's client software.

11. By mid-1995, there were browsers other than Booklink in the marketplace. Netscape, in particular, had developed a popular browser, known as Navigator. Netscape's browser was an innovative and widely-used product that had been well

received in the marketplace. As a result, by mid-1995 Netscape had a significant number of users and a strong competitive presence and reputation. At that same time, it was well known that Microsoft was developing a browser (ultimately known as Internet Explorer) for use with its Windows 95 operating system, released in August of that year. Microsoft's browser, however, did not in mid-1995 have the same extensive usage or marketplace position that Netscape enjoyed.

12. Prior to my arrival at the company in September, 1995, AOL had been assessing whether to continue to rely exclusively on its Booklink browser or to seek to license a third party browser. By the time I joined the company, AOL had concluded that it would require a significant expenditure of resources to improve and upgrade the Booklink browser to remain competitive with the Netscape browser and with what AOL believed was likely in the future to be a competitive Microsoft browser. AOL concluded that, given the difficult and expensive process that would be required to improve and upgrade Booklink, it was worth exploring the possibility of obtaining a license to distribute an existing third party browser with AOL's client software.

The Competitive Environment

13. In 1995, Microsoft was, as it is now, the leading supplier of personal computer operating systems. In August of that year, it launched Windows 95, which became one of the fastest selling software products in history.

14. In connection with its introduction of Windows 95, Microsoft became a direct competitor of AOL by launching its own online service known as The Microsoft Network ("MSN"). Microsoft included MSN code in its Windows 95 operating system,

and placed an MSN icon on the Windows 95 desktop.

15. Because Microsoft was the largest operating system provider, Microsoft had a potentially decisive strategic advantage in competing against other online service providers such as AOL through its ability to bundle MSN with the Windows operating system and to place an MSN icon in a prominent position on the desktop. By August 1995, Microsoft had already begun to include MSN in every copy of Windows 95 that it shipped, both to personal computer manufacturers (so-called OEMs) and in retail copies. By doing so, Microsoft was able to ensure that every consumer who purchased either a new computer or a Windows 95 product at retail had MSN easily available. To subscribe to the Microsoft online service, a consumer would merely have to click on the MSN icon that appeared on the desktop when he or she turned on the computer.

16. Because a large majority of the personal computers sold in this country include the Windows operating system, Microsoft was thus to achieve virtually costless distribution of MSN to almost every new computer user.

17. By contrast to MSN's virtually cost-free distribution, AOL was forced to rely on other, more expensive methods of distributing its software. Those methods included the mailing out of disks or CDs to individual potential subscribers as well as the distribution of disks and CDs at public events such as sporting events and concerts. In addition to being more costly than the method used by Microsoft to distribute MSN, those methods required more effort by the consumer to access AOL than was required to access MSN. In particular, a consumer who wanted to access the AOL service would have to take the time to actually load the disc or CD into his or her computer,

install and configure the AOL client software and then access the AOL service.

18. AOL recognized that having its software already loaded on a computer when it was purchased by a consumer would be a uniquely effective method of distribution, and that placement of its icon on the desktop would be a uniquely effective method of promotion and installation. It also recognized that Microsoft's ability to bundle MSN with its operating system and place an MSN icon on the desktop ensured that MSN would be immediately available on almost every computer purchased by a consumer. While AOL sought to obtain a similar form of distribution by entering into agreements with individual OEMs to have its software preinstalled on their personal computers, AOL was required to pay acquisition fees, or bounties, to the OEMs for each new subscriber that AOL obtained in that manner. Microsoft, by contrast, did not incur such fees when it bundled MSN with its Windows operating systems, and no single computer manufacturer had the same ubiquitous market position as that held by the Microsoft operating system.

19. Because of Microsoft's distribution advantages, AOL became very concerned that the bundling of MSN into the Windows operating system and the inclusion of an MSN icon on the desktop would put AOL at a severe and unfair competitive disadvantage to MSN.

20. Moreover, the bundling of MSN with Windows 95 and the inclusion of an MSN icon on the desktop created a sense in the marketplace that MSN's commercial success was inevitable, whatever the merits of that service. AOL thus complained publicly and to the Department of Justice in the summer of 1995 about what it felt was

Microsoft's ability to use its market position in operating systems to gain an unfair advantage in the online services business.

21. Netscape, on the other hand, had (in 1995) the leading market position in the browser market. At the time, Netscape was focusing on selling software to end users, corporations and through partnerships with online and Internet service providers. It was not at that time a direct competitor to AOL, and that factor, coupled with the brand name, market position and features of the Netscape browser, made it the obvious choice for AOL licensing. Indeed, Netscape told AOL that it had no intention of entering the online services business, but rather planned to license software to other entities who wanted to enter that business. Those representations were important to AOL, since AOL believed that it was possible that the Netscape browser could eventually become a platform comparable in certain respects to an operating system. Were this to occur, and were the Netscape browser to become as ubiquitous as the Microsoft operating system, AOL was concerned that such a market position could be misused to favor affiliated applications, and could create the same kinds of unfair competitive advantages that AOL was facing with respect to MSN. These concerns formed the context for the negotiations described below with Netscape and Microsoft in the latter part of 1995 and early 1996.

AOL's Negotiations With Netscape

22. AOL entered into active negotiations with Netscape in approximately October 1995. These negotiations resulted in the Netscape Agreement signed on March 11, 1996, which created a browser licensing arrangement, a significant aspect of

which was the promise by Netscape to develop, at AOL's request and cost, a componentized browser that AOL could integrate into its client software.

(AOL-0003474; AOL-0003240.)

AOL's Negotiations with Microsoft

23. Sometime in late 1995, Microsoft indicated its interest in licensing to AOL its browser, Internet Explorer. I understood that Microsoft was aware that AOL was then negotiating with Netscape for a license of the Netscape browser.

(AOL-M-0000163; AOL-M-0000818; AOL-M-0000799.)

24. At some point in AOL's discussion with Microsoft, Microsoft indicated that it might be willing to consider including AOL in some form in the Windows operating system. (AOL-M-0000818.) After substantial discussions, Microsoft offered to put an "Online Services" folder icon on the desktop, and to include an AOL icon and the code needed to install AOL's client software in that folder. This offered AOL an opportunity to achieve a form of distribution and promotion in Windows 95 and on its desktop that, while not comparable to that accorded to MSN, was nonetheless of immense value to AOL. The willingness of Microsoft to bundle AOL in some form with the Windows operating system was a critically important competitive factor that was impossible for Netscape to match.

25. AOL would not have been willing to negotiate a browser license with Microsoft had Microsoft not indicated a willingness to bundle and to promote the AOL client software in some form with Windows. Distribution and promotion on the Windows desktop was one of AOL's goals -- indeed, the most significant one -- in

negotiating a browser agreement with Microsoft. The value of distribution through and promotion on the Windows desktop was something that Netscape could not provide.

26. As the negotiations with Microsoft and Netscape progressed, there were four other, less significant considerations in AOL's mind in deciding how to proceed. First, AOL wanted a browser with the necessary functionality to meet its members' needs, and to improve its members' experience over that offered by Booklink. Second, AOL wanted the flexibility of being able to integrate different browsers into its client software, thus providing its users a choice of browsers. (AOL-0001131; AOL-0002908; AOL-0001140; AOL-0002989; AOL-M-0000979; AOL-0002866.) Third, AOL wanted the lowest possible cost for a browser. And finally, AOL wanted to ensure that its browser would remain fully interoperable with the ubiquitous Windows operating system. Because Microsoft was the leading producer of operating systems as well as a competitor (through MSN) of AOL, AOL did not want to have any incompatibility between its products and Microsoft, or any concern in the marketplace that its software was not fully compatible with Windows.

27. Throughout the negotiations with Microsoft, I was aware that Microsoft was concerned that AOL might choose instead to complete a deal with Netscape. Indeed, once Microsoft indicated a willingness to consider desktop placement somewhere for AOL, I sought in the negotiations to obtain as much prominence as possible. Microsoft refused to provide placement of an AOL icon on the desktop itself or to include our software code in its operating system (as it had done with MSN); however, Microsoft ultimately did agree to provide an AOL icon in the Online Services

Folder (which would reside on the desktop and display a list of Internet access providers when a user clicked on it)

28. During the negotiations, AOL also sought to maintain flexibility in its browser distribution and promotion. It was AOL's objective to have both Navigator and Internet Explorer available to its members, allowing them to choose which browser to use. Microsoft, on the other hand, attempted to secure exclusive distribution and promotion for Internet Explorer, with no or few exceptions for distribution or promotion of a competitive browser. AOL ultimately agreed to these restrictions in order to obtain bundling with Windows and placement in the Online Services Folder. In the end, the deal struck with Microsoft was a trade-off: AOL obtained a form of bundling with the Windows 95 operating system and promotion on the Windows 95 desktop, and Microsoft obtained virtual exclusivity for its browser on AOL, preventing AOL from providing any significant promotion or distribution of Netscape's Navigator browser.

29. AOL signed its browser agreement with Microsoft on March 12, 1996. (AOL-0001724.) Pursuant to this agreement, Microsoft licensed Internet Explorer to AOL, and it became the default browser for use in the AOL client software. The agreement also provided that the AOL software would be distributed (along with other online service providers) with Windows 95 and with any subsequent consumer Windows operating system and also promoted in the Online Services folder. In return, the agreement provided for virtual exclusivity in favor of Internet Explorer on AOL. AOL was only permitted to ship another browser when required by a third party provider, distributor or corporate account, and only after taking all reasonable efforts to cause

the third party to distribute the third party browser on its own; even then, the number of third party browsers that AOL could distribute was limited to less than 15% of AOL's total browser shipments.

30. As a result of the Microsoft agreement, AOL must and does strictly limit its distribution, promotion and advertising of Netscape Navigator. Microsoft has sought to strictly enforce these restrictions, and has carefully monitored references to Navigator or Netscape on the AOL service.

31. AOL was willing to agree to virtual exclusivity with Microsoft – something to which AOL would not otherwise have agreed – because AOL believed that inclusion in the Windows operating system and on the desktop was essential to mitigate, at least partially, the adverse competitive effects of Microsoft's bundling of MSN with its operating system, and because such inclusion had very significant distributional advantages that could not be obtained in any other way.

32. Thus, AOL was concerned about broader competitive issues in its negotiations about a browser license, beyond the relative merits of the Microsoft and Netscape products. In particular, Microsoft (through MSN) was a powerful existing competitor, seeking what AOL perceived was an unfair competitive advantage through the bundling of MSN with its operating system. Only Microsoft had the ability to provide, both for MSN and AOL, essentially ubiquitous distribution through the vehicle of the Windows operating system. AOL engaged in these negotiations from that perspective, with its goal to enter into an agreement that met its browser needs and was overall the most advantageous to AOL and its members.

The Merits of the Two Browsers

33. During the negotiations with Netscape and Microsoft, AOL employees expressed various views with respect to the merits of the two browsers. Generally speaking, as I mentioned above, both Navigator and Internet Explorer were viewed within AOL as comparable and, in any event, superior to AOL's then-existing Booklink browser. Netscape had a robust browser that had been tested in the marketplace; it had more and better features, and was viewed by many as the more important brand in the Internet space. Microsoft, on the other hand, had a browser that was already componentized, but which had not been as thoroughly tested and which was not as robust. During the negotiations with the two companies, each of them promised to fix the weaknesses that we perceived with their particular browsers. AOL believed that by the time that AOL was ready to use a browser in its next release of its client software, the two browsers would be comparable (indeed probably essentially indistinguishable).

34. As I noted above, componentization was important to AOL. AOL wanted a browser that would connect seamlessly to the AOL software consistent with AOL's desire to provide an AOL "feel" to its members during their online experience even if they were using the browser to access the Internet. While both the Netscape and Microsoft browsers would have required some engineering before they could have been integrated into the AOL client software, the Microsoft browser was already componentized. Because it was, AOL could connect it to the AOL software in a seamless fashion. The Netscape browser, on the other hand, was not yet componentized, so Netscape would have had to develop such a browser for use by

AOL. In the agreement with Netscape, AOL required that Netscape componentize its browser. At the time it entered into the March 1996 agreement with Netscape, AOL believed that Netscape was capable of creating, and was prepared to create, a componentized browser.

AOL's Relationship With Netscape Following the Microsoft Agreement

35. AOL's relationship with Netscape necessarily has been affected by AOL's March 1996 and subsequent agreements with Microsoft. Not surprisingly, Netscape did not complete its development of a componentized browser given the restrictions in the Microsoft agreement that would have sharply limited AOL's ability to distribute or promote that browser. Given Microsoft's refusal to allow AOL to give Netscape any significant distribution and promotion, I understood that Netscape did not want to expend the resources necessary to develop a componentized browser specifically for AOL, and AOL did not attempt to enforce that obligation.

36. AOL has nevertheless sought to work with Netscape to the extent permitted by the Microsoft agreements. While the parties did enter into an agreement with Netscape for the distribution of AOL's instant messenger e-mail service, known as "AIM," in October 1997, the restrictions in the Microsoft agreements prevented AOL from compensating Netscape through distribution or promotion of its browser on the AOL service. (AOL-0000277.)

AOL's Other Agreements with Microsoft

37. Since the March 12, 1996 agreement, AOL has entered into several other agreements with Microsoft. In so doing, AOL has had to take into account the fact that

Microsoft has made various changes in its Windows operating system and desktops that would likely have the effect of diminishing the value to AOL of the terms of the March 1996 agreement, and thus increasing the relative competitive advantages that MSN and Microsoft's other more recent online service offerings enjoy in competition with AOL.

a. The Promotional Services Agreement

38. On October 28, 1996, AOL and Microsoft entered into an additional promotional agreement for Internet Explorer known as the Promotional Services Agreement; this agreement was subsequently amended on December 19, 1996. (AOL-0000135.) (AOL-0000133-0000134.) Pursuant to this agreement, Microsoft agreed to pay AOL \$.25 per member for each member that AOL successfully converted to Internet Explorer from another browser. In addition, Microsoft agreed to pay AOL \$600,000 if AOL succeeded in converting a substantial portion of its installed base to Internet Explorer by a certain date. (AOL-0001438.) During these negotiations, I was told that Microsoft had no limitations on what it could spend to gain market share for Internet Explorer. (AOL 0002877.) This agreement added additional obligations for AOL to exclusively promote the Internet Explorer in particular locations on the AOL browser, on CD-roms of the AOL client software, and on sales material related to the AOL 4.0 product.

39. I understood that converting the installed base of AOL users to Internet Explorer was an important goal for Microsoft.

b. The Active Desktop Agreement

40. AOL entered into the Active Desktop Marketing, Promotion and Distribution agreement with Microsoft in September 1997. (AOL-0000123.) Release 4.0 of Internet Explorer included a so-called channel bar on the desktop that points to content and services that were both already available on the computer and that have links out to the Internet. If a user sought to use one of those links and did not already have an Internet service provider, the user would automatically be sent to the so-called Internet Connection Wizard ("ICW"), which takes the user to a referral server that included promotions for a number of Internet service providers. Because this channel bar would be present on the desktop, it would make it easier for consumers to reach certain content and services that were linked to the channel bar, and thus seemed likely to provide those entities included on the channel bar with a competitive advantage over those entities that were not included in the channel bar.

41. AOL believed that the practical effect of the active desktop was to reduce the effectiveness of the Online Services folder by pushing it down to a lower and less visible level. AOL was concerned that Microsoft's purpose in doing this was at least in part to dilute the benefits that AOL had bargained for in the March 1996 agreement. At the time, AOL believed that the channel bar and active desktop would be more successful than they have been, and believed that since MSN would be immediately available on the desktop and prominently displayed in the channel bar, it was important that AOL be included in the channel bar as well. (AOL-0001372; AOL-0001373; AOL-0000828.)

42. In order to obtain this position in the channel bar, AOL agreed to a variety

of additional restrictions on its ability to promote and distribute certain other browsers, including Navigator. For example, the agreement prohibited AOL from (1) promoting Navigator within AOL Web sites (with a limited exception for paid advertising), and from compensating Netscape for marketing, distributing or promoting AOL content.

c. The Windows 95 Referral Server Agreement

43. In Windows 95, Microsoft introduced the Internet Referral Server ("IRS"), accessed through the ICW. This placed an icon on the Windows 95 desktop with equal prominence to the Online Services Folder. If a user clicked on the icon, they would be directed to the ICW, which would then launch a series of ICW screens to lead a user through the process of selecting an Internet service provider.

44. AOL and Microsoft negotiated over AOL's inclusion in the Internet Referral Server, and ultimately signed an agreement in February 1998. (MS98-0101383.) The agreement secured placement for AOL in the Internet Referral Server (accessed through the ICW) for Windows 95 (although for various reasons that has not yet been implemented). AOL was required to pay a per-subscriber bounty to Microsoft for the right to be included in the IRS.

d. The Windows 98 ICW Agreement

45. In Windows 98, when a user first starts a new computer, a welcome screen appears which includes four links, one of which is to the ICW. That screen will continue appearing until the user clicks on all four links and completes the tasks related thereto, or affirmatively prevents the screen from reappearing. As was the case with Windows 95, the ICW would take the user to a referral server, from which the user

could initiate service with such a provider. The Windows 98 ICW had the effect of further reducing the visibility and value of the Online Services Folder to AOL, since it was interposed before the desktop on which the Online Services Folder resides. In fact, AOL's perception was that one of Microsoft's objectives was to further reduce the distributional protections that AOL had bargained for in March of 1996. For all these reasons, AOL felt that it was even more important to be included as one of the providers in the referral server. This was particularly true because of Microsoft's continuing efforts to promote its own online services businesses, including MSN, on the desktop, and to make it easy for consumers to access them. AOL continued to believe that it needed to have as close to comparable exposure as possible to whatever Microsoft online services Microsoft was seeking to promote.

46. Because of this concern, AOL entered into the Internet-Sign Up Wizard Referral Agreement with Microsoft in October 1998. Pursuant to this agreement, AOL will be one of many Internet service providers included in the ICW, but AOL will have a slightly different treatment with respect to how a user gets connected to AOL than is the case for other Internet service providers.

AOL's Present Intentions Regarding Browsers

47. AOL's March 1996 agreement with Microsoft continues for several years, but AOL can elect at the end of this year not to continue the exclusivity and Online Service Folder provisions in the 1996 Microsoft agreement. At this point, Navigator and Internet Explorer continue to be reasonably comparable browser solutions. Particularly since Microsoft is a direct and significant competitor to AOL, AOL would be

inclined to license the Netscape browser, at least to provide it as an option to AOL members. Given the importance of continuing to be included in the Windows operating system and desktop, however, AOL's present intention is to opt to continue with the provisions of the 1996 Microsoft agreement, for several reasons. First, Microsoft has demanded that AOL continue with these exclusivity provisions or lose the right of CompuServe to be included in the Online Services Folder and the ICW, and for AOL to continue to be listed in the referral server. Second, Microsoft's increased presence in the browser market has left Netscape, at least at this point, in a weakened state. Third, AOL continues to want to ensure, to the extent possible, that there will be neither real interoperability problems between the Windows operating system and AOL, nor any perception in the marketplace that this could occur.

Conclusion

48. AOL would not have been willing to negotiate a browser license with Microsoft had Microsoft not been willing to bundle and promote AOL in its Windows operating system and on its desktop. And AOL would not have been prepared to accept the restrictions on its distribution and promotion of Netscape Navigator had Microsoft not insisted on those restrictions as an element of the licensing agreement. While AOL viewed the Netscape and Microsoft browsers as comparable (and in each case an improvement over AOL's Booklink browser), distribution and promotion in the Windows operating systems was something that Netscape simply could not provide.

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